To: Gary Gensler – Chair, Securities and Exchange Commission

From: Hal Scott – President, Committee on Capital Markets Regulation

Date: October 17, 2022

Re: File Number S7-03-22: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-5955 (Mar. 24, 2022).

On behalf of the Committee on Capital Markets Regulation,[1] we submit this memorandum to follow up on our conversation of October 4, 2022, in which we discussed the statutory authority of the Securities and Exchange Commission ("SEC") for its rulemaking proposal "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" (the "Private Funds Proposal").[2] We present herein our analysis of why the sections of the Investment Advisers Act of 1940 (the "Advisers Act") that the SEC cites[3] as authority for its proposed prohibition on private fund adviser indemnification do not authorize such a prohibition. Although this memorandum focuses on only one narrow aspect of the proposal, we continue to believe that the SEC lacks statutory authority for various other aspects thereof, as further discussed in the Committee on Capital Markets Regulation's comment letter on this proposal.[4]

I. Question Presented

Does the SEC have the legal authority under Section 211(h), 206(4), or 215 of the Advisers Act to prohibit investment advisers to private funds from seeking indemnification by the private fund or its investors against ordinary negligence in providing services to the private fund?

II. Short Answer

No. These Sections of the Advisers Act do not authorize the SEC to prohibit such provisions.

III. Facts

In the Private Funds Proposal the SEC proposes to enact a rule making it impermissible for any investment adviser to a private fund to, among other things, "directly or indirectly . . . seek reimbursement, *indemnification*, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, *negligence*, or recklessness

[1] The Committee on Capital Markets Regulation is an independent 501(c)(3) research organization. The Committee is dedicated to developing efficient capital markets and ensuring the stability of the financial system.

[2] SEC. & EXCH. COMM'N, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, 87 Fed. Reg. 16,886 (Mar. 24, 2022), https://www.federalregister.gov/documents/2022/03/24/2022-03212/private-fund-advisers-documentation-of-registered-investment-adviser-compliance-reviews (the "Proposing Release").

[3] Proposing Release at 16,974.

[4] *See,* COMM. ON CAP. MKTS. REGUL., Comment Letter re. "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" (Apr. 25, 2022), https://www.capmktsreg.org/wp-content/uploads/2022/04/CCMR-Comment-Letter-Private-Funds-Proposal-04.25.2022.pdf.

in providing services to the private fund . . . ." (emphasis added).[5] To the extent the foregoing prohibition prohibits indemnification provisions excusing ordinary negligence, we refer to it as the "Indemnification Prohibition."

As statutory authority for the Indemnification Prohibition, the SEC cites Sections 211(h) and 206(4) of the Advisers Act. The Private Funds Proposal also suggests that Advisers Act Section 215 may justify the Indemnification Prohibition.[6] We therefore also assess the applicability of Advisers Act Section 215.

Section 211(h) of the Advisers Act was enacted under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[7] in 2010 following the 2008 financial crisis. Part of the purpose of Dodd-Frank generally, and the purpose of Section 913 specifically, was to strengthen and harmonize the regulation of broker-dealers and investment advisers, particularly addressing problematic techniques for the sale and provision of financial products and investment advice to retail investors. The need for these reforms was described in a report by the Treasury Department that observed "[r]etail investors face a large array of investment products and often turn to financial intermediaries – whether investment advisers or brokers-dealers – to help them manage their investments [but] investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks" and called for the SEC to be "empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest."[8] The reforms that address these issues are effected in Section 913 of Dodd-Frank.[9]

Dodd-Frank Section 913 begins by defining the term "retail customer"[10] and requiring the SEC to conduct a study of the standards of care for broker-dealers and investment advisers with respect to the provision of "personalized investment advice and recommendations about securities to retail customers."[11] It authorizes the SEC to adopt rules addressing those standards "as necessary or appropriate in the public interest and for the protection of retail customers."[12] Following that authorization, Section 913 adds Section 211(h) to the Advisers Act under the subheading "Other Matters."[13] It provides that the SEC shall:

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[5] Proposing Release at 16,977 (Proposed Rule § 275.211(h)(2)-1(a)(5)).
[6] *See id*. at 16,925, Note 171.
[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1623 (2010).
[8] *See* DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71-72 (2009), https://fraser.stlouisfed.org/title/financial-regulatory-reform5123 (the "Treasury Report").
[9] *See* S. REP. NO. 111-176, at 105 (2010), https://www.congress.gov/congressional-report/111th-congress/senate-report/176/1 ("Section 913 . . . directs the SEC to conduct a study of the effectiveness of existing legal or regulatory standards of care for brokers, dealers, and investment advisers for providing personalized investment advice and recommendations about securities to retail customers.").
[10] *See* Dodd-Frank § 913(a) ("For purposes of this section, the term 'retail customer' means a natural person, or the legal representative of such natural person, who— (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes.").
[11] *Id.* § 913(b)(1).
[12] *Id.* § 913(f).
[13] *Id.* § 913(g)(2).

> "(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and
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> (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

Section 206(4) of the Advisers Act, which predates Dodd-Frank, provides that:

> "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
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> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Section 215 of the Advisers Act , which also predates Dodd-Frank, provides that:

> "(a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void.
>
> (b) Every contract made in violation of any provision of this title and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision."

IV. ANALYSIS

1. Section 211(h) does not authorize the Indemnification Prohibition.

Section 211(h)[14] does not authorize the Indemnification Prohibition for three reasons—each of which is independently fatal to the SEC's authority. First, Section 211(h) is intended to provide the SEC with the authority to protect retail investors specifically, *not* private funds or the investors in private funds. Second, Section 211(h) only authorizes the prohibition of "sales practices," "conflicts of interest," or "compensation schemes," and indemnification provisions are not "sales practices," "conflicts of interest," or "compensation schemes." The Indemnification Prohibition

[14] Unless otherwise stated, references to "Sections" herein refer to the Sections of the Advisers Act.

does not address conduct falling within the meaning of any of these terms. Third, even assuming indemnification provisions were otherwise covered by Section 211(h), the SEC could not reasonably deem indemnification provisions against ordinary negligence to be "contrary to the public interest and the protection of investors." Subparts a, b, and c below discuss these three issues in turn.

a. Section 211(h) does not authorize the SEC to regulate the advisers of private funds.

The statutory context and legislative history of Section 211(h) indicate that Section 211(h) is intended to authorize SEC rulemaking only with respect to the provision of investment advisory and broker-dealer services to *retail* customers.

As the Supreme Court stated in *FDA v. Brown & Williamson Tobacco Corp.*, "[i]t is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme."[15]

Section 211(h) was added to the Advisers Act pursuant to Section 913(g) of the Dodd-Frank Act, which, as described above, is focused on granting the SEC power to establish a standard of conduct as to retail customers of broker-dealers and investment advisers ("retail investors"). The "overall statutory scheme" therefore indicates that Section 211(h) should be read to relate to retail investors in particular, not investors generally.

The legislative history of Section 211(h) also evidences an intention to protect retail investors only. The Treasury Department report that instigated the reform that became Section 211(h) called for new legislation that should prohibit "certain conflicts of interest and sales practices that are contrary to the interest of investors."[16] The report explained that its proposals were necessitated by the fact that "retail investors face a wide array of investment products" and are "often confused about the differences between investment advisers and broker-dealers."[17] This clearly indicates that the purpose of Section 211(h) is the protection of retail investors.

Dodd-Frank Section 913 defines "retail customer" as a "natural person, or the legal representative of such natural person, who— (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes."[18]

This definition categorically excludes institutional investors. However, it is institutional investors, primarily pension funds, that the SEC cites as needing the protection of its prohibited activities rule, including the Indemnification Prohibition.[19] Such investors are clearly not "retail customers" and are thus outside the intended scope of Dodd-Frank Section 913 and Advisers Act Section 211(h).

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[15] 529 U.S. 120, 133 (2000).
[16] Treasury Report at 72.
[17] *Id.* at 71.
[18] Dodd-Frank § 913(a).
[19] *See* Proposing Release at 16,887.

Although some investors in private funds are natural persons, they must be either "accredited investors" (investors with a net worth of $1 million or more or $200,000 or more in income over a multi-year period)[20] or, in the case of private funds with more than 100 investors, "qualified purchasers" (investors with $5 million or more in investments).[21] According to a 2018 estimate, only 2% of U.S. investors meet the qualified purchaser standard.[22] Access to such funds is thus limited to the wealthiest individual investors on the basis of their greater sophistication and risk tolerance. Assuming for argument's sake that the Indemnification Prohibition addresses conduct described in Section 211, we believe that a prohibition of commercial terms applicable to institutional investors based on the presence of natural person investors consisting of the wealthiest population in the United States would be viewed by a court as outside the scope of the SEC's authority in the absence of a clear mandate by Congress. While Dodd Frank Section 913 sought to protect retail investors, the SEC acknowledged that the investors who are subject to the sales practices or related conduct of private funds are "institutional investors" such as retirement plans, trusts, sovereign wealth funds, insurance companies, state government pension plans, university endowments as well as "wealthy individuals."[23] To the extent that individuals that are less wealthy have indirect exposure to private funds, it is through institutions such as pension funds and endowments, as the SEC acknowledges.[24] This means that they benefit from the sophistication, bargaining power, and legal counsel that qualify the institution to invest directly in those funds. Accordingly, Dodd-Frank Section 913's authorization to protect "retail customers" does not extend to private funds.

Under the major questions doctrine, for an agency to assert rulemaking authority to change a statute from "one sort of scheme of . . . regulation into an entirely different kind" the agency must point to "clear congressional authorization."[25] Dodd-Frank Section 913 as well as the Advisers Act and Investment Company Act of 1940 (the "Company Act") reflect a fundamental distinction between the regulation of advisory services and investment funds that are limited to accredited investors and qualified purchasers and those that are publicly available to retail investors. Company Act-registered funds are subject to extensive regulation. Federal law, for example, governs everything from their board[26] to their capital structure.[27] To apply Section 211(h) to private funds would ignore this distinction. Neither Section 211(h) nor the other cited sections of the Advisers Act contain any such express authorization for the SEC to upend the basics of the statutory and regulatory scheme that Congress has laid out. As we argue below, the opposite is the case: interpreting the cited sections of the Advisers Act to authorize the Indemnification Prohibition directly conflicts with the statutory language. Regardless, if the SEC adopts a rule applicable to private funds and institutional investors in reliance on statutory authority limited to protections for retail investors, the SEC would be acting outside any Congressional authorization.

[20] 17 C.F.R. § 230.501(a).
[21] 15 U.S.C. § 80a-2(a)(51).
[22] *See* CCMR, Expanding Opportunities for Investors and Retirees: Private Equity 2 (2018), https://www.capmktsreg.org/wp-content/uploads/2018/10/Private-Equity-Report-FINAL-1.pdf.
[23] *See* Proposing Release at 16,935.
[24] *See id.* at 16,887.
[25] *West Virginia v. EPA*, 59 U.S. __ (2022).
[26] *See* Company Act § 10.
[27] *See id.*§ 18.

b. Indemnification provisions are not covered by the language of Section 211(h).

Even assuming, *arguendo*, that Section 211(h) applied to investment advisers to private funds, the statutory language of that section does not contemplate rulemaking with respect to indemnification provisions or for that matter any contractual provisions, either explicitly or implicitly. Section 211(h) only authorizes the prohibition of "sales practices," "conflicts of interest," and "compensation schemes." Section 211(h) does not refer to indemnification provisions or other similar contractual provisions. The Treasury Report that ultimately engendered Section 211(h) makes no mention of indemnification or contractual provisions. Courts will generally not interpret a statute to effect a fundamental change to a regulatory scheme by implication or omission.

An indemnification provision is not a sales practice, conflict of interest or compensation scheme and therefore the prohibition of indemnification provisions cannot be rationally linked to the protection of investors from undesirable instances of sales practices, conflicts, and compensation schemes. The term "indemnification" is commonly defined as the act of "secur[ing] *against* [or] mak[ing] compensation for . . . hurt, loss, or damage."[28] An indemnification provision in an investment advisory agreement for ordinary negligence means that if the adviser acts with ordinary negligence and thereby causes damages to the fund, then the fund and its investors generally cannot obtain compensation from the adviser for the adviser's negligent behavior.

i) <u>An indemnification clause is not a "sales practice."</u>

"Sales" is commonly defined as "operations and activities involved in promoting and selling goods or services" and "practice" as a "repeated or customary action."[29] The plain meaning of "sales practice" could thus be reasonably stated as a repeated or customary manner of promoting or selling goods. There is no reasonable interpretation of that term that could be read to encompass an indemnification provision for ordinary negligence. In particular, one could not reasonably characterize an indemnification clause in favor of an investment adviser as a selling point for investors in the private fund. When the term "sales practice" has been used in other financial regulations, it has referred to and limited the methods used to market or provide certain goods or services and not methods by which sellers seek to protect themselves from liability.[30]

ii) <u>An indemnification clause is not a "compensation scheme."</u>

"Compensation" is commonly defined as "payment" or "remuneration" or "something that constitutes an equivalent or recompense"[31] and a "scheme" as a "plan or program of action" or

[28] *See* MERRIAM-WEBSTER.COM DICTIONARY, "Indemnification" and "Indemnify," https://www.merriam-webster.com/dictionary/indemnification (last visited Oct. 13, 2022).
[29] *See* MERRIAM-WEBSTER.COM DICTIONARY, "Sales" and "Practice" https://www.merriam-webster.com/dictionary/sale; https://www.merriam-webster.com/dictionary/practice (last visited Oct. 13, 2022).
[30] *See, e.g.,* 17 CFR § 240.15g-9 (using "sales practice" to specify methods by which a broker must verify a customer's financial situation and provide specified disclosure before executing transactions in penny stocks); 12 CFR § 1011.20 (prohibiting "sales practices" that involve deceptive means of inducing a person to buy or lease certain real property).
[31] *See* MERRIAM-WEBSTER.COM DICTIONARY, "Compensation" https://www.merriam-webster.com/dictionary/compensation (last visited Oct. 13, 2022).

"systematic or organized configuration."[32] The legislative history indicates that Section 211(h) and its related provisions in Dodd-Frank arose out of a need to curtail marketing and promotional techniques whereby an intermediary received payments for selling particular financial products to a customer, which were determined to have contributed in part to the 2008 financial crisis. For example, the Treasury Report refers to "side payments" received by mortgage brokers and other intermediaries from the originators of financial products or mortgages.[33] "Compensation scheme" in the context of Section 211(h) should therefore be read to refer to value received by the service provider for the marketing or promotion of certain services or investments. Indeed, as the SEC itself has acknowledged, the paradigmatic example of a "compensation scheme" in the brokerage or investment management context is a "sales quota or bonus" that incentivizes individuals within the organization providing the brokerage or advisory services to push customers to select certain securities over others.[34] Indemnification, however, does not result in any payment or remuneration of the adviser for the marketing of its services to investors.

iii) <u>An indemnification clause is not a "conflict of interest."</u>

A "conflict of interest" is commonly defined as "a conflict between competing duties."[35] An indemnification provision against negligence does not fit this definition.

The Proposed Rule does not cite factors showing that indemnification provisions for ordinary negligence in favor of private fund advisers present any conflicts of interest. The Proposed Rule simply alleges that such provisions "put[] the adviser's interests ahead of the interests of its private fund client."[36] Such an interpretation of a conflict of interest, however, leads to an absurd result, because the adviser and its client are not aligned with respect to any provision in an investment advisory agreement that grants a right to the investment adviser or imposes an obligation on the client. The provision that entitles the adviser to a fee paid out of the fund's capital would be just one example, because it mandates a transfer of value from the fund to the adviser. Moreover, an indemnification provision is not a conflict of interest because it does not give the adviser an incentive to act with negligence. Even if the provision results in the adviser being less careful, the adviser is not advancing its interests by doing so and, in fact, doing so would, at a minimum, result in reputational harm.

In addition, the principle of *ejusdem generis* further demonstrates that "conflict of interest" does not refer to an indemnification provision for ordinary negligence. Under this principle, when a statute lists items in a way that reflects an intention to refer to the same subject-matter, courts will interpret those items as referring to "generally similar" things.[37] As noted above, a sales bonus is a paradigmatic example of a compensation scheme. It also constitutes a sales practice and conflict of interest. The three phrases thus seem to be commonly targeted at payments to sales personnel

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[32] *See* MERRIAM-WEBSTER.COM DICTIONARY, "Scheme" https://www.merriam-webster.com/dictionary/scheme (last visited Oct. 13, 2022).
[33] *See* Treasury Report at 68.
[34] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86,031, 84 Fed. Reg. 33,318, 33,454 (July 12, 2019).
[35] *See* MERRIAM-WEBSTER.COM DICTIONARY, "Conflict of interest" https://www.merriam-webster.com/dictionary/conflict%20of%20interest (last visited Oct. 13, 2022).
[36] Proposing Release at 16,889.
[37] *See Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 274 (2013).

that create incentives to put retail customers in unsuitable products. An indemnification provision does not contemplate incentive payments to the adviser – any payments thereunder would merely offset the adviser's liability for damages. Nor are such provisions a method by which an adviser seeks to induce an investor to subscribe to a particular fund – quite the opposite, they better enable the adviser to take on the obligation of advising by mitigating the risk of disproportionate liability. The surrounding language thus makes it even more evident that "conflict of interest" does not refer to an indemnification provision.

Case law and related statutes also establish that indemnification provisions do not constitute conflicts of interest. Provisions that limit a financial service provider's liability to its customer for ordinary negligence are routinely enforced by courts, including against even individual retail consumers rather than the sophisticated clients of private funds. For example, in *Stark* the court confirmed that under New York law a fiduciary can exclude its liability for ordinary negligence by valid contract, including a trustee for a trust established by and for the benefit of individual persons.[38] Such provisions are also explicitly permitted by state statute: for example, both New York and Delaware permit corporations to indemnify an officer or director for ordinary negligence.[39] Courts have also confirmed that similar provisions are not *per se* problematic in a contract between an investment adviser and its retail client. In the case of *Hsu v. UBS*[40] the Ninth Circuit dismissed an argument that characterized a clause limiting an investment adviser's liability to its retail customers as *per se* invalid. Moreover, courts tend to enforce provisions that are negotiated by contracting parties with full knowledge of their contents and effects, especially when the counterparties are sophisticated and advised by legal counsel.[41] If a private fund investor contends that a particular indemnification provision is invalid due to inadequate disclosure, there are remedies available to it, including under the Advisers Act, as discussed in section 3 below. The Indemnification Prohibition would thus ignore and moot a body of contractual law that courts have developed and refined over decades.

An interpretation that would incorporate an indemnification provision within the meaning of a conflict of interest is also undermined by Section 17 of the Company Act. Section 17 of the Company Act permits registered investment companies, which are available to all retail investors, including those that do not meet qualified purchaser or accredited investor standards, to agree to indemnification clauses covering ordinary negligence with the fund's investment adviser. More specifically, Section 17(i) of the Company Act provides in relevant part that "no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or

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[38] *Stark v. United States Trust Co.*, 445 F. Supp. 670, 683 (S.D.N.Y. 1978). *See also*, *Colnaghi U.S.A., Ltd. v. Jewelers Protection Services, Ltd.*, 81 N.Y.2d 821, 823, 595 N.Y.S.2d 381, 382 (1993) (""New York law generally enforces contractual provisions absolving a party from its own negligence."); *Morrissey v. Curran*, 351 F. Supp. 775, 782 (S.D.N.Y. 1972) (trust exoneration provisions will protect the trustee against liability for negligence); *Jones v. First Nat'l Bank of Ft. Lauderdale*, 226 So.2d 834, 835 (Fla.Dist.Ct.App. 1969) ("a trust agreement may contain exculpatory provisions whereby a trustee may, at least in circumstances involving ordinary negligence and honest errors of judgment, be relieved of liability for breach of trust"); *Jarvis v. Boatmen's Nat'l Bank of St. Louis*, 478 S.W.2d 266, 274 (Mo. 1972) (exculpatory clause that limited testamentary trustee's liability to acts involving willful default was valid and not contrary to public policy).
[39] Del. C. Ann., tit. 8, § 145(a); N.Y.Bus. Corp. Law § 722.
[40] 2013 WL 492443 at *1.
[41] *See, e.g.*, *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544 (Del. Ch. 2001).

purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or *gross* negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement [emphasis added]."[42] This language is notable in its specification of "gross" negligence, which indicates that Section 17(i) does not prohibit provisions that protect an adviser to a public fund against liability for ordinary negligence. Indeed, such provisions are common in investment advisory agreements between such public funds and their advisers.[43] To prohibit funds reserved for the wealthiest and most sophisticated investors from agreeing voluntarily to a provision that is permitted to funds available to retail investors would be completely inconsistent with the statutory scheme that Congress set out in the Advisers Act and Company Act, whereby advisers to funds available to the public are more closely circumscribed in their conduct with respect to their advised funds. As noted above, under the major questions doctrine, the SEC must point to clear congressional authorization to effect such a change. However, no such authorization is available and indeed the contemplated Indemnification Prohibition would be at odds with a statutory scheme that has been in place for decades.

c. Indemnification provisions for ordinary negligence between private funds and their advisers cannot reasonably be deemed to be "contrary to the public interest and investor protection."

As noted above, investment advisory agreements between Company Act-registered funds and their advisers commonly provide for the indemnification of the adviser for ordinary negligence.[44] And courts routinely enforce indemnification provisions, including in contracts for the provision of investment advisory services to retail investors and the funds in which they invest. The distinction between ordinary negligence and higher forms of culpability is also of central relevance in an equivalent context in corporate securities law. In the case of *Globus*, the court specified that certain indemnities by issuers of underwriters are against public policy but clarified that such indemnities do *not* include indemnification for mere ordinary negligence.[45]

To treat indemnification and similar arrangements protecting investment advisers to private funds from claims of ordinary negligence as "contrary to the public interest and investor protection" would push the meaning of "public interest and investor protection" to the breaking point, given that these arrangements are commonplace in the market and represent long-accepted methods of allocating risk for investment advisers to retail investors.

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[42] Company Act Section 17(i).
[43] *See, e.g.*, Investment Advisory Agreement Between Sierra Income Corporation and SIC Advisors LLC, section 8(a) (Apr. 5, 2012), https://www.sec.gov/Archives/edgar/data/1523526/000119312512157394/d305269dex99g1.htm; Investment Advisory Agreement Between CPG Vintage Access Fund III and Central Park Advisers, LLC, section 7(a) (July 10, 2019) https://www.sec.gov/Archives/edgar/data/1780338/000114420419041000/tv528029_ex99g1.htm.
[44] *See id*.
[45] *See Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (1969).

2. Section 206(4) does not authorize the Indemnification Prohibition.

Section 206(4) does not authorize the Indemnification Prohibition because there is no rational basis for characterizing an indemnification provision for ordinary negligence as "fraudulent, deceptive, or manipulative." Section 206(4) provides that as part of exercising its rulemaking authority under that section, the SEC must "define" the "fraudulent, deceptive, or manipulative" act or practice that it intends to prohibit. The Proposed Rule offers no definition of any indemnification provision that characterizes them as "fraudulent, deceptive, or manipulative."

Even if the Proposing Release had defined an indemnification provision for ordinary negligence as a "fraudulent, deceptive, or manipulative" act or practice, to declare an entire category of contractual provisions that are routinely enforced by courts in various commercial contexts as *per se* "fraudulent, deceptive, or manipulate" would be a reach too far. The common definitions of these three terms all imply an attempt to mislead or improperly influence.[46] There is nothing inherently deceptive or misleading about an indemnification provision for ordinary negligence that is clearly disclosed to the indemnifying party – if there were courts would not enforce them.[47] That is all the more true with respect to the sophisticated investors in private funds. Such a characterization would moreover imply that in enacting Section 17(i) of the Company Act to allow registered investment companies to enter into contracts that indemnify or waive its adviser's liability for ordinary negligence, Congress specifically intended to permit these funds to enter into "fraudulent, deceptive, or manipulative" agreements and that the existing advisory agreements between registered funds and their advisers constitute an ongoing fraud against those funds.

3. Section 215 does not authorize the Indemnification Prohibition.

Section 215 provides that a contract that purports to waive a party's rights under the Advisers Act or that requires a party to violate the Advisers Act is void. The Private Funds Proposal suggests that the Indemnification Prohibition is authorized by Section 215 because all indemnification provisions in private fund advisory contracts are *per se* violations of the adviser's fiduciary duties, and thus violations of the Advisers Act that are void under Section 215.

This argument fails for two reasons: (1) Section 215 does not authorize agency rulemaking but, according to the Supreme Court, creates a private right of action under which a litigant may seek rescission of a contract for a violation of the Advisers Act, and (2) the argument that indemnification provisions for ordinary negligence are *per se* violations of the Advisers Act is unsupported in the language of the Advisers Act and inconsistent with decades of jurisprudence.

First, there is no language in Section 215 that authorizes the SEC to promulgate rules. Instead, as the Supreme Court held in *Transamerica v. Lewis*, Section 215 creates a private right of action under which a customer can seek to void a contract with its investment adviser by alleging a

[46] *See* MERRIAM-WEBSTER.COM DICTIONARY, "Fraud," https://www.merriam-webster.com/dictionary/fraud; "Deceptive," https://www.merriam-webster.com/dictionary/deceptive; "Manipulative" https://www.merriam-webster.com/dictionary/manipulative (last visited Oct. 13, 2022).

[47] *See Cohen v. Santoianni*, 330 Mass. 187, 193 (1953) (indicating that presence of fraud can render a contract unenforceable).

violation of the Advisers Act.[48] The Ninth Circuit held consistently in *Hsu*.[49] There is nothing in the "equitable cause of action"[50] created in Section 215 that authorizes the SEC to ban indemnification clauses outright, or to effectively mandate a private right of action under state law for negligence (which is the practical effect of banning indemnification clauses).

Second, nothing in Section 215 or otherwise in the Advisers Act indicates that indemnification provisions for ordinary negligence are *per se* violations of its terms. Courts have also declined to adopt such a blanket approach. Instead, courts assess whether a litigant is entitled to an equitable remedy such as rescission on a case-by-case basis with reference to the circumstances and relevant laws. If a private fund investor believes that a particular indemnification provision violates the Advisers Act and is thus voidable under Section 215, the court would assess the argument with reference to the facts of that case. Prohibiting by rule all indemnification provisions for ordinary negligence based on Section 215 would in effect prejudge all such cases by finding for the plaintiff. The prohibition would thus usurp the role of the courts.

Moreover, courts would almost certainly not rule for the plaintiff in all such cases given that federal and state courts in various U.S. jurisdictions have declined to declare indemnification provisions for ordinary negligence as *per se* violations of the Advisers Act or breaches of fiduciary duty.[51] In considering petitions for equitable relief, a court will, among other things, look at the totality of the circumstances and will not apply a forward-looking injunctive prohibition of the sort proposed in the Indemnification Prohibition. Indeed, many fact-intensive defenses are available to dismiss claims asserting equitable remedies. The Indemnification Prohibition would also be inconsistent with the SEC's approach to such provisions since the SEC's inception, as well as the terms of the Company Act, which specifically authorize such provisions.

We commend to the SEC a review of the U.S. Supreme Court's jurisprudence regarding equitable remedies. Indeed, the Court applies a "cautious approach to equitable powers, which leaves any substantial expansion of past practice to Congress."[52] Adopting a novel rule prohibiting terms mutually agreed among sophisticated parties based on the potential for an equitable remedy to be available in a court is, in our view, an overly simplistic and fatally incorrect reading of the Court's jurisprudence on equitable remedies and an agency's statutory authority. At a minimum, we believe that the SEC must conduct a more detailed review of the equitable remedies jurisprudence before the U.S. Supreme Court, and not rely on mere assertions that equitable remedies provide the SEC with a basis of rulemaking authority.

[48] *See Transamerica v. Lewis*, 444 U.S. 11 (1979).
[49] *See Hsu supra* note 40.
[50] *See Transamerica supra* note 48.
[51] *See id.,* cases cited *supra* note 38.
[52] *See Grupo Mexicano de Desarrollo, S. A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 309 (1999).

V. Conclusion

Neither Section 211(h), Section 206(4), nor Section 215 of the Advisers Act authorizes the SEC to prohibit investment advisers to private funds from seeking indemnification by the private fund or its investors against ordinary negligence in providing services to the private fund.

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PRESIDENT